



EXPANDING THE MARKET: FINANCIAL INSTITUTIONS AND AGRICULTURAL LENDING

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Intervention in the rural financial market

UNTIL THE 1990s, THE DOMINANT PRACTICE in developing rural financial markets was to rely on specialized credit institutions that ensured that priority sectors and underprivileged clientele were provided with financial services, particularly credit. The implied function of these development finance institutions (DFIs) was to improve social welfare by lending to a sector—agriculture—often associated with low profitability and high risk, and therefore not financially attractive to private, for-profit, financial institutions. By bringing financial services to the rural sector, DFIs attempted also to increase food security and alleviate poverty. These institutions received subsidized resources from the state and/or donors, as the unfettered market would have charged higher rates for these resources.

Many countries concentrated on enhancing the operations of DFIs rather than creating an enabling environment for private, for-profit lenders, such as banks. Indeed, not only were banks wary of lending to agriculture, but they usually lacked the capacity to service the sector effectively. Banks in countries transitioning to market economies are thrust into unfamiliar decision-making roles and are ill-equipped to immediately begin making crucial decisions on credit allocation, pricing loan and savings products, and, particularly, evaluating risk. Nonetheless, there were common assumptions that if DFIs were drastically reduced, then for-profit financial institutions would instantly emerge to service the agricultural sector. Clearly this proved to be a naïve expectation.

Some countries have assisted in establishing non-bank financial institutions (NBFIs), such as credit cooperatives, credit unions and village banks. Their advantages often lie in the capacity to cut administrative costs, better assess the credit risk of potential borrowers, and the fact that peer pressure helps ensure repayment. NBFI loan collection rates often exceed 90%. Usually these institutions require subsidization during the initial stages of operation. Also easy entry, mainly through setting a low minimum capital requirement compared to banks, is required to ensure that NBFIs compete with other financial institutions.

As many countries emerge from command to more open economies, state and donor initiatives that seek to enhance rural finance must determine if support should go through existing banks or units that specifically implement rural or agricultural credit projects. Often, the latter course is chosen because of the perception that existing banks don't have the human capital or institutional capacity to cope with the diversified, complex tasks open economies present to financial institutions. Donors often include a technical assistance component in projects; yet building this capacity is a long-term process.

Evaluating interventions

Technical assistance was a large component of two rural finance projects implemented by the World Bank in Latvia. In its evaluation, the World Bank judged these projects as successful due to the technical

assistance and the fact that adequate economic, agricultural and financial policies were in place. Incentives for both borrowers and the financial institutions were considered crucial to the success of the projects. However, the evaluation did not attempt to quantify the cost to society of these substantial incentives, which took the form of a grant that amounted to 30% of the total loan value. Such a costly subsidy may generate artificial demand from investors that may face relatively poor return on the full investment but high return on their own funds (equity) invested when the grant embedded in the loan is taken into account. This, in turn, could lead to misallocation of scarce resources because eventually investments with poor social internal rates of return would be financed.

The “success” of these two projects can be compared to the evaluation carried out in 2003 of all World Bank financial intermediary loans in developing countries, including microfinance projects launched between 1993-2002. Two primary assessment criteria rated the performance of the financial institutions regarding their *outreach* to the target clientele and their *subsidy dependence* (i.e., the cost to society of the intervention). Scores ranged from 1 (very weak) to 5 (outstanding). The average score was 2.77, with rural microfinance projects scoring significantly below (2.11) the non-rural microfinance projects (3.13). Performance did not improve significantly over time. These World Bank loans paid inadequate attention to the viability of the financial institutions involved, thereby failing to pursue sustainability and to measure progress towards achieving it along predetermined milestones.

A crucial factor separating failed projects from successful ones in this study is human capacity: the knowledge and ability of the project officers. This capacity includes their ability to resist pressure to lend prematurely or in too-large amounts, design incentive systems to induce borrowers to repay, screen borrowers, and adequately price loan and saving products. Though technical assistance was a major design component of the projects, the design usually was confined to inputs (e.g., “two person-months of a consultant will be dedicated to improve the managerial information system”) but rarely to outputs (e.g., “the improved managerial information system will report not later than five days after the end of the month on loan collection, arrears, age analysis of arrears, etc.”).

Enhancing interventions

Developing human capital can be an especially demanding task in countries making the painful transition to a market economy. Much of the accumulated knowledge of banks in former command economies has become irrelevant. The need to upgrade the human capital of financial institutions is a long-term and needed task, yet there are several other factors that can be addressed as donors and governments seek to make rural lending more attractive.

High transactions costs. Micro, small and even medium-sized loans are characterized by high transactions cost when measured against the average annual value of the loan granted. Reducing a lender’s transactions costs through subsidies that are capped, reduced over time and eventually eliminated can help induce for-profit financial intermediaries to serve rural clientele earlier. The subsidies should be related to actual delivery of credit and savings products. Instruments that reduce transactions costs can be classified as *general* (e.g., ATMs, credit scoring models) or *rural-specific* (e.g., mobile banks and village credit unions). Mobile banking and group lending helped substantially reduce transactions costs in Latvia, Moldova and Albania.

High real and perceived risks. Financial institutions can introduce instruments to reduce real and/or perceived risk, helping transform some rural clients perceived as not creditworthy into creditworthy ones. Risk is often addressed by improved screening of borrowers and requiring that borrowers generate income from more than one source. Crop (index based) insurance and minimum price insurance can reduce the credit risk of the financial institution. Familiarity with techniques of risk management can improve the financial performance of the financial institutions. When judicial and enforcement systems function well, the risk and cost to creditors’ is lowered and consequently financial services expand. Improvements in these areas are usually inexpensive and can start immediately, irrespective of the economic situation in the country concerned.

Credit scoring models can help overcome high perceived risk. Registry of borrowers’ loans-collection performance within a credit bureau and extending it to cover not only negative but positive information could close the gap between the high perceived risk and the lower actual risk, as well as facilitating adequate pricing of the financial products offered by the

financial institutions that better reflect their assumed, actual risk.

Lack of borrower collateral. Developing substitutes like social capital and group guarantees, and promoting leasing and partial guarantees, could mitigate the lack of adequate collateral by many rural borrowers. The focus should be on expanding items that can serve as collateral and making repossession an easy and inexpensive procedure, thereby reducing credit risk and enhancing outreach.

Shortage of term credit. This is mostly the result of the shallow financial intermediation structure, lack of complementary markets, and public unwillingness to save in monetary instruments for long periods because of uncertainty about the future. Intervention should be handled with care and particular consideration should be given to not over-subsidizing long-term lending and to ensuring that a sound yield curve is created and maintained. Over time, the share of banks delivering long-term credit should be increased, while the share of state or donor provision of these resources should be decreased and eventually eliminated. The state's role should mainly be one of controlling inflation and ensuring that rates of exchange are not manipulated, thereby leading to supply of market-oriented, long-term credit that does not rely on administrative allocation and concessionary terms. When a bank's reluctance to lend long term originates from its risk assessment and not from liquidity considerations, then partial guarantees on long-term loans can help convince banks to gradually bear additional long-term credit risk. These guarantees should be capped, reduced over time and eventually eliminated.

Benchmark of best practices

If the goal is to create a subsidy-free organization that is financially self-sustaining, then there is a clear precedent. BRI-Unit Desa (BUD) in Indonesia transformed a failed state-owned bank specializing in agricultural lending into a subsidy-independent rural finance institution. BUD's success started the "micro-finance revolution" and introduced profound changes in targeting clientele, modes of operation, and the pricing of lending and savings instruments.

The Subsidy Dependence Index (SDI) measures the full value of implicit and explicit subsidies received by a financial institution, including the opportunity cost of capital against the sum of interest income and fees paid by borrowers. This ratio also indicates the change

needed in the yield obtained on the loan portfolio in order to nullify the subsidy. BUD achieved self-sustainability (SDI of zero) only two years after commencing operations and has been running a negative SDI since then, while generating profits unprecedented in rural finance operations or in universal banking, yielding 5-6% return on assets. Presently, BUD serves more than 27 million deposit accounts and more than 2.7 million loan accounts with a variety of financial services, generating a substantially favorable impact on rural development yet with no need for support from government. BUD's success in shifting the paradigm from traditional agricultural credit to rural financial intermediation can be found in several key features.

Wide borrower eligibility. Client targeting was not narrowly focused on farmers but broadened to include any profitable rural enterprise. The main criteria for loan approval are projected cash flow from use of the loan that allows repayment.

No mandatory savings. BUD does not have an obligatory savings program. Forced saving obscures both the cost of credit to the borrower and the actual net credit outstanding. BUD mobilizes voluntary savings from people who want to save excess funds and lends that money to creditworthy people who wish to borrow.

Flexible collateral requirements. Legally required to take collateral, BUD was flexible in doing so. It would take a pledge of anything the borrower owned, such as furniture. Documentation of the collateral was more for the purpose of establishing the borrower's serious intent to repay than to provide a basis for legal action.

Easily understood maturity and repayment terms. BUD established several possible maturities and repayment schedules to match the cash flow of the enterprise taking a loan.

Maximum and minimum loan sizes. The maximum loan size initially set by BUD determined whether the system could reach the low-income clientele and eventually achieve break-even status. The maximum loan was set at 1 million rupees (about US\$1,000 in 1984) and gradually increased to 25 million rupees (about US\$13,500) by 1990. A loan of about 120,000 rupees covers staff time to approve a loan, collect installments, and pursue borrowers in default. The minimum loan has remained 25,000 rupees (about \$10 in 1996). The average outstanding loan was about US\$500 in 1996 and is now about US\$700.



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Appropriate interest rates. The interest rate was set so that BUD could break even within two years. It was estimated that a monthly interest rate of 1.5% on the original loan amount could accomplish this. No charges were levied other than interest (i.e., no fees) because culturally such charges would represent corruption. Every six months, as incentive, borrowers who paid on time were refunded a sum equal to a flat interest rate of half a percent per month.

BUD's SDI was about -44% in 1995, meaning that it could reduce yield obtained on its loan portfolio by 44% (from 33% to about 18%) and still obtain sound profitability as measured by return on equity and assets. The negative SDI of BUD reflects its remarkable financial performance, but it also brings up the question of whether high profitability that results from very high lending rates is an optimal social policy. In general, the practices promoted by BUD shed light on crucial issues related to success or failure in rural financial intermediation.

Rural finance in transition

Rural finance projects shouldn't merely replicate what was successfully implemented in another country, but rather should adapt lessons to the socioeconomic conditions and cultural values prevailing in the country concerned. Yet some clear recommendations can be gleaned from past experiences.

Limited access to credit is not always the binding constraint to rural income growth. Often, issues such as deficiencies in the legal, regulatory, supervisory and enforcement systems, inadequate agricultural or financial policies, and the lack of marketing facilities and limited insurance markets must be addressed first (or simultaneously) to ensure that credit delivery generates expected results. Corrective measures in legal and regulatory reform can be undertaken immediately. Such measures include reforming laws governing secured transactions, improving land titling and registration,

promoting credit scoring and registering, and deregulating lending and deposit service provisions. The state should seek to ensure a stable macro-economy, low or zero inflation, and an adequate, not manipulated exchange rate. Creating a favorable environment for NBFIs, which often implement microfinance best practices, can extend outreach to rural clientele.

Microfinance usually insists on a frequent loan repayment that is not appropriate for households exclusively engaged in farming. However, farming households that also generate income from other sources can make the frequent loan repayments. Microfinance lending also suits dairy operations that generate daily income. After becoming established with non-agricultural lending, some microfinance projects have started lending to the agriculture sector, realizing that this can diversify their risk and increase lending volume. Microfinance lending rates are much higher than interest rates at banks. The transactions costs of microfinance institutions are also much higher than those of banks. Therefore, sustainability requires that they apply these higher interest rates.

Finally, there are two primary assessment criteria in evaluating the performance of interventions in rural financial markets: extended *outreach* to the target clientele and progress toward *subsidy independence*.



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